

Internal Revenue Service

Number: **200703018**

Release Date: 1/19/2007

Index Number: 472.05-01

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:ITA:B06

PLR-125049-06

Date:

October 17, 2006

LEGEND

Taxpayer =

Parent =

Country 1 =

Date 1 =

Date 2 =

Date 3 =

Dollar Amount A =

Dollar Amount B =

Dollar Amount C =

Dollar Amount D =

Dollar Amount E =

Dollar Amount F =

Number X =

Number Y =

Percentage 1 =

Percentage 2 =

Percentage 3 =

Percentage 4 =

Year 1 =

Year 2 =

Year 3 =

Dear :

This letter is in response to the letter submitted by Taxpayer's authorized representatives in which a ruling was requested regarding the conformity requirements of sections 472(c), 472(e)(2), and 472(g) of the Internal Revenue Code. Specifically, the ruling requested is that Parent, a foreign corporation, may issue consolidated financial statements to its shareholders and creditors reporting U.S. subsidiaries' operations other than on a last-in, first-out (LIFO) basis without violating the LIFO conformity requirement set forth in §§ 472(c), (e)(2), and (g).

Parent is a corporation organized under the laws of Country 1. For financial statement purposes, Parent is subject to generally accepted accounting principles of Country 1. Taxpayer is a wholly-owned U.S. subsidiary of Parent. The activities of Parent, Taxpayer, and Taxpayer's subsidiaries are reported on the consolidated financial statements of Parent.

Parent values its inventory in its worldwide consolidated financial statements on a non-LIFO basis. For Country 1 tax purposes, Parent likewise uses a non-LIFO method of accounting for inventories.

Taxpayer and its U.S. subsidiaries join in the filing of a consolidated U.S. federal income tax return using a 52-53 week tax year ending each year on Date 1. Taxpayer's U.S. subsidiaries (U.S. Subs) use the LIFO method of valuing inventory for federal income tax purposes.

Parent began its business operations in Year 1 in Country 1, where it operates as a franchisor and warehouse supplier of franchised retail stores. Under the franchise

agreements Parent supplies franchisees with Percentage 1 of the products stocked in the stores. Parent provides its network of franchised stores with centralized purchasing, distribution, marketing, training, human resources, management, operational consulting, and information systems services, as well as participation in the Parent's private label program. As of Date 2, Number X stores operate in Country 1 under the Parent's franchise banner.

Parent owns significant Country 1 real estate assets that it leases to franchisees relating to Number Y of the store locations. The balance of the store locations are leased by Parent who subleases the locations to franchisees. Parent's ownership of the Country 1 real estate assets enables it to ensure that prime store locations remain under the banner of the Parent's name.

Per Parent's financial statements as of Date 2, revenues from Country 1 operations were Dollar Amount A, and revenues from Country 1 operations were expected to be in excess of Dollar Amount B for the year ending Date 3. Such revenues were Dollar Amount C for the prior year-end. The book value of Country 1 assets as of Date 2 was Dollar Amount D, which constituted Percentage 2 of total worldwide assets. As of Date 2 Country 1 operating income was Dollar Amount E, which constituted Percentage 3 of total worldwide operating income. Further as of Date 2, Country 1 earnings before interest, taxes, depreciation and amortization (EBITDA) was Dollar Amount F, which constituted Percentage 4 of total worldwide EBITDA.

Parent via Taxpayer began owning and operating retail outlets in the U.S. in Year 2, and has grown its U.S. business primarily through a series of acquisitions. Taxpayer's most recent acquisition of U.S. subsidiaries in Year 3 significantly increased the level of U.S. operations, and thus reduced the relative percentage of Country 1 assets compared to total worldwide assets. Accordingly, the percentage of operating assets used by the worldwide group in foreign operations, as reflected in the consolidated financial statements of the group, constitutes less than 30 percent of the total worldwide operating assets. Since Taxpayer's Year 3 acquisition of U.S. subsidiaries, Country 1 revenues have increased in total, while the number of franchised retail stores has remained substantially the same.

Taxpayer requests the following rulings:

- (1) That Parent has substantial foreign operations within the meaning of Rev. Rul. 78-246, 1978-1 C.B. 146; and
- (2) Consequently, the issuance of consolidated financial statements by Parent to its shareholders and creditors reporting the U.S. Subs' operations on a non-LIFO basis does not violate the LIFO conformity requirement set forth in I.R.C. §§ 472(c), (e)(2), and (g).

Section 472(c) provides that a taxpayer that elects to use the LIFO inventory method for federal income tax purposes must establish to the satisfaction of the Commissioner that it has used no method other than LIFO in inventorying goods specified in its LIFO election to ascertain income, profit, or loss for the first taxable year for which the method is to be used, for the purpose of a report or statement covering such taxable year to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.

Section 472(e)(2) imposes a requirement similar to that contained in section 472(c) for taxable years subsequent to the year of the LIFO election and provides that the taxpayer may be required to discontinue the use of the LIFO inventory method if this requirement is violated.

Section 472(g) provides that all members of the same group of financially related corporations are treated as a single taxpayer for purposes of the LIFO conformity requirement of sections 472(c) and (e)(2). The term "group of financially related corporations" means any affiliated group as defined in section 1504(a), determined by substituting "50" percent for 80 percent each place it appears, and any group of corporations that consolidate or combine for purposes of financial statements.

Rev. Rul. 78-246 holds that it is inappropriate to impose the LIFO method of inventory valuation upon a foreign parent corporation with respect to the inventory of any subsidiary that uses the LIFO method of accounting for federal income tax purposes when the group is engaged in substantial foreign operations. Accordingly, the LIFO method of accounting need not be used in the consolidated financial statements issued by a foreign parent corporation provided that the foreign parent owns, either directly or through members of its consolidated group, operating assets of substantial value which are used in foreign operations.

Rev. Rul. 78-246 provides that operating assets are considered to be used in foreign operations if they are owned by, and used in the business of, corporations that: (1) are members of the consolidated group; (2) are foreign corporations; (3) do not use the LIFO method of accounting for federal income tax purposes; and (4) engage in a business outside the U.S. Operating assets for purposes of this test are all the assets necessary for the conduct of an active operating company. The foreign parent corporation will be considered as owning substantial foreign assets if the total value of such assets constitutes 30 percent or more of the total operating assets of the consolidated group (the 30 percent test). This determination will be made annually and normally will be made on the basis of the asset valuation reflected in the consolidated financial statements of the group for the year.

Rev. Rul. 78-246 further holds that whether a foreign parent is engaged in substantial foreign operations will be decided on the basis of all the facts and circumstances presented if the consolidated group does not satisfy the foregoing 30 percent test.

Taxpayer represents that it does not meet the 30 percent test for establishing substantial foreign operations under Rev. Rul. 78-246. Thus, to fall within the provision of Rev. Rul. 78-246, Parent must be engaged in substantial foreign operations based on all the facts and circumstances.

We conclude that Parent is engaged in substantial foreign operations on the basis of all the facts and circumstances presented. The scale of Parent's foreign operations is substantial as evidenced by several financial factors, including the amounts of its revenues and assets that are attributable to the operation of an active business in Country 1. Further, the profitability of Parent's foreign assets is underscored by the amounts of operating income and EBITDA generated by its active business operations in Country 1, as well as the substantial percentages that those amounts constitute of the total worldwide amounts of operating income and EBITDA.

Operational factors also indicate the substantiality of Parent's active foreign operations. Parent first established its business operations in Country 1 before expanding into the U.S. market. In this regard, Parent has developed, substantially supplied and serviced a significant number of franchised retail outlets in Country 1. Further, Parent both owns and leases numerous store locations to franchisees, and leases then subleases numerous store locations to franchisees, to ensure that prime store locations remain under the banner of the Parent's name.

Accordingly, it is ruled that, for federal income tax purposes:

- (1) For Parent's fiscal year ending Date 3, on the basis of all the facts and circumstances presented, Parent has substantial foreign operations within the meaning of Rev. Rul. 78-246, 1978-1 C.B. 146; and
- (2) Consequently, for the fiscal year ending Date 3, the issuance of consolidated financial statements by Parent to its shareholders and creditors reporting the U.S. Subs' operations on a non-LIFO basis does not violate the LIFO conformity requirement set forth in I.R.C. §§ 472(c), (e)(2), and (g).

This ruling applies only to the taxable year ending Date 3 and does not apply to any subsequent taxable year. Specifically, no opinion is stated as to whether Parent has substantial foreign operations for subsequent years, or whether Parent may issue consolidated financial statements for subsequent years reporting U.S. Subs' operations on a non-LIFO basis without violating the LIFO conformity requirements.

In addition, Taxpayer and U.S. Subs must otherwise comply with the LIFO conformity requirements of sections 472(c), (e)(2) and (g) in inventorying their goods to ascertain income, profit, or loss for the purposes of a report or statement (covering the taxable year for which the LIFO method is used) to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes.

As provided under section 1.472-3(d) of the Income Tax Regulations, whether or not the LIFO method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns. Accordingly, this letter should not be construed as a ruling as to whether Taxpayer's or U.S. Subs' use of the LIFO inventory method and relevant computations are in accordance with section 472 and the regulations thereunder.

A copy of this letter should be attached to Taxpayer's consolidated federal income tax return for the taxable year ended Date 3. Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Jeffery G. Mitchell
Chief, Branch 6
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: